

Real choices in the new Dutch pension contract

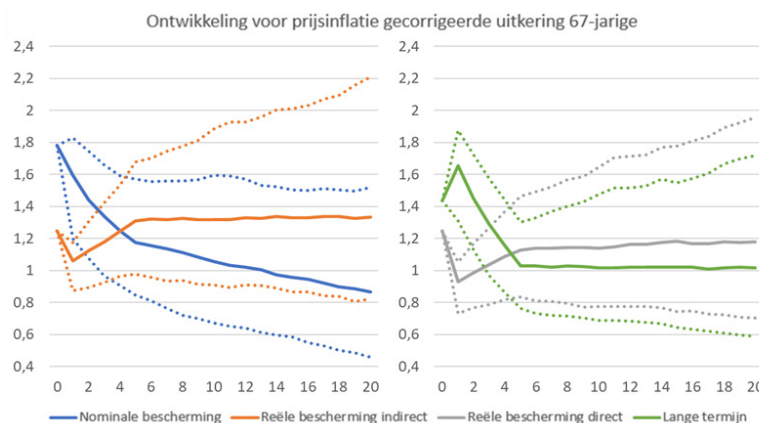
“How to deal with purchasing power risks in the benefits of the new Dutch pension contract”

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In the design of the new Dutch pension contract several instruments are available to deal with expected and unexpected inflation. In this paper we analyze the impact of these instruments. Expected inflation can be compensated by reducing the initial benefit. Unexpected inflation can be covered using the solidarity reserve provided the inflation shocks are not too sizable and persistent. More important though is the choice of the investment strategy, the hedge returns and the allocation of excess returns.

Principal Findings

- Because a sufficiently deep market for index bonds on Dutch inflation is lacking, it is not possible for the large funds to fully hedge their inflation risks in the investments.
- Risk sharing using an indirect real hedge return can be attractive, also in communication, but is legally not allowed.
- Temporary inflation shocks can be absorbed by the solidarity reserve. The solidarity reserve will often be too small, though, to cover persistent inflation shocks.
- Risk sharing between groups of participants, e.g. by young participants that cover the inflation risks of older participants, may, dependent on the investment strategy, imply substantial risks for the group absorbing the risk.



The figure shows the evolution of pension benefits under four different policies for the assumed interest rate and hedge returns. Benefits are adjusted for price inflation. Stochastic scenarios all start with a large unexpected shock to inflation.

Key Takeaways for the Industry

- In case of nominal hedge returns and a nominal investment strategy, persistent inflation shocks imply too high benefits in the first years.
- Protecting the pensioner's benefits against expected and unexpected inflation is usually possible but implies lower benefits in the first years a benefit is received.
- Inflation protection could be made more effective by adjusting the pension regulations.



Want to know more? Read the paper

'Reële keuzes in het nieuwe pensioencontract'